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SUBJECT: ELECTRICITY SUBSIDIES END BUT PROBLEMS CONTINUE

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11. SUMMARY: The GOES announced on March 23 that electricity subsidies will be discontinued. This change is expected to raise energy costs by 60% for industrial and 30% for residential customers. Industry groups have criticized the government's failure to honor an agreement to phase out the subsidy and they warn of inflationary effects. Though generally supporting the change, energy firms say their liquidity problems will continue and additional measures will be needed to put the industry on more stable footing. They are pressing for quarterly electricity rate adjustments to reduce their financing needs. Energy companies are reaching out to President-elect Funes' transition teams to raise these concerns and discuss a planned transition to long-term energy contracts under a cost-based dispatch system. END SUMMARY.

ELECTRICITY SUBSIDY ENDS

12. Presidential Chief of Staff Eduardo Ayala Grimaldi announced on March 23 that electricity subsidies will be ended due to lack of funding. His statement signals that the electricity regulator, SIGET, will allow electricity rates to rise at the next biannual "tariff reset" on April 12, when SIGET must either schedule subsidy payments or adjust rates to reflect average energy costs during the previous six-month period. Distribution companies had already stopped applying electricity subsidies after February 11 because the government failed to pay \$15.7 million per month subsidy bills for March-April. However, since the GOES committed to paying the January subsidy bill only on February 9 (after companies had been applying unsubsidized energy rates for nearly a month), the change to full energy tariffs was masked by the reimbursement of January subsidies to customers on their February-March bills.

13. Distribution companies estimate that the elimination of subsidies will raise average electricity rates by 30% for residential customers and 50% for industry. Several business groups criticized the government's failure to honor an agreement to gradually eliminate the subsidy for commercial users in three phases, and some warned that rising energy costs will have inflationary effects. When industry groups protested a decision in July 2008 to remove energy subsidies for industry, the GOES agreed to phase out the subsidies in three stages in August 2008, April 2009 and October 2009.

14. Electricity companies project that the April subsidy bill (for the period October 2008-March 2009) will rise to \$98.2 million, higher than the \$94.6 million March-October 2008 bill that the GOES has failed to pay off. Since the GOES will not pay this amount, electricity companies will raise their rates to recover the subsidy over the next six months. Generation companies note that savings from declining fuel prices have been offset by a 70% increase in prices by the state-owned generator Comision Ejecutiva Hidroelectrica del Rio Lempa (CEL) for hydroelectric and geothermal energy from

71\$ per MWH in November 2007 to 120\$ per MWH one year later. CEL was forced to raise its wholesale energy prices to compensate for credits it issued to cover the subsidy, but it lowered its average price to 88\$ in March after the subsidy was lifted.

LIQUIDITY PROBLEMS CONTINUE

15. With distribution companies unable to pay their March power bill in full by the March 24 due date, the GOES extended the payment deadline for \$17 million (roughly 30% of their monthly energy bill) to April 6, but required firms to pay interest (at a 14% annual rate) on late payments. The companies point out that their liquidity problems have been largely caused by the government policy to adjust rates only every 6 months. Even with the subsidy ended, El Salvador's price stabilization scheme only allows distribution companies to collect \$66 per MWH for current consumption, while the difference between this price and the real energy cost is deferred to the next semester. With wholesale energy prices projected to average roughly \$139 per MWH for the current six-month period (October 2008-March 2009), the accumulation of deferred payments is likely to surpass \$200 million, including taxes, or more than half of the total energy bill. With CEL's prices now reduced, average energy prices fell to \$117 in March and should remain lower during the next semester.

16. Energy companies also note that the GOES does not pay interest or penalties for its own late payments, including a \$5 million monthly subsidy payment for low-income customers who use less than 99 kilowatt-hours per month. The government's postponement of this payment from March 20 to March 31 also contributed to distributors' bill payment problems.

17. Distribution companies (led by U.S.-based AES) warn that, in the short term, the end of subsidies may worsen their existing cash-flow problems since bill collections will take longer than lump-sum subsidy payments from CEL. Companies note that Salvadoran law requires a 60-day grace period before they can disconnect customers for delinquent bills. With industrial power rates rising sharply during an economic downturn, managers are concerned that collection problems may increase.

INDUSTRY WANTS QUARTERLY RATE ADJUSTMENTS

18. Energy companies want the GOES to change from semi-annual to quarterly "tariff resets" to alleviate cash-flow problems caused by the time-lag in rate adjustments. The industry has hired a consulting firm to study how to implement this transition and estimate the cost. Companies estimate that the GOES and/or customers will need to pay roughly \$100 million to shift to quarterly tariff adjustments. This amount represents three months of delayed payments that energy companies would need to recover.

INDUSTRY CONCERNED OVER TRANSITION TO LONG-TERM CONTRACTS

19. Energy companies have also raised several concerns over the planned transition of El Salvador's energy market to a cost-based dispatch system with long-term energy contracts. In a March 20 meeting with the Charge, distribution company managers requested Mission support to help the GOES ensure a competitive process for soliciting long-term contracts with a level playing field for different energy sources. They are concerned that a recently launched solicitation for a 320 MW long-term contract favors thermal generators and fails to realistically address current financial constraints. While the GOES is seeking technical assistance in addressing these concerns, energy firms are not confident that regulators will address these financial issues.

110. Generation companies are also pressing for open bidding

on capacity payments, the component of long-term energy contracts intended to reduce investment risks by guaranteeing payments for installed capacity, before the transition to cost-based pricing begins in January 2010. One manager told Econoff earlier that the capacity payment issue was "the next fight" (after the subsidy issue) as generators consider this a critical policy to ensure future investment. The companies have criticized the government for setting fixed capacity payment of only \$6 per kwh based on investment costs for gas turbines, the cheapest generator which is not used in El Salvador. They argue that this amount is far too low to ensure the recovery of their investments.

¶11. The GOES counters that capacity payments are intended to only partially reduce investment risks, but companies can prepare their bids for variable costs to include recovery of additional investment costs. They say that investment costs for a gas turbine were used, following a Chilean model, because these turbines have the highest variable cost, so the low fixed capacity payment allows all energy sources to compete on a level playing-field.

INDUSTRY PLANS OUTREACH TO TRANSITION TEAMS

¶12. During a March 24 AmCham Energy Committee meeting, energy companies discussed efforts to raise their concerns with members of President-elect Funes' transition team. Several members expressed cautious optimism that Funes' team will consult with the energy industry and listen to their concerns. They noted he has supported positive moves to focus subsidies and he appears to be assigning pragmatic advisors to handle energy policy. Industry leaders have already met with several of Funes' economic advisors, including economist Alex Segovia and FMLN legislator Blanca Coto, who is expected to play a leading role on energy issues. Members noted that Coto is seen as an FMLN moderate who has made comments sympathetic to the private sector.

¶13. In an earlier meeting with Econoff, Axel Soderberg, an informal FMLN energy advisor and Vice-Rector of Universidad Centro-Americana (UCA), predicted the FMLN would strengthen the leadership role of the national energy commission and mandate increased renewable energy production. After a series of seven meetings with FMLN legislators and advisors to discuss energy policy, Soderberg said they moderated their more radical proposals and accepted the need for private sector involvement in the electricity sector.

COMMENT

¶14. The elimination of electricity subsidies is a big step towards more sustainable energy policies, but additional policy reforms will be needed. The effects of the subsidy will be seen in suddenly higher energy prices and continuing liquidity problems. In the short-term, it is unlikely that the GOES will shift to quarterly payments in the April tariff reset, but industry will press for this change to be made at the October 2009 tariff reset. The early outreach by electricity companies to the Funes transition team reflects a rapid shift in the business community from aggressive support for ARENA during the campaign to pragmatic engagement with Funes and his transition team.

¶15. The current government and incoming administration knew that the unsustainable electricity subsidies would have to be addressed. In light of their electoral loss, the Saca administration no longer feels obligated to keep President Saca's promise not to raise electricity rates prior to June ¶2009. This saves the Funes administration from having to take this unpopular step.

¶16. While the abrupt elimination of the subsidy will take a large toll, especially at a time of general economic distress, it was a necessary action. The next step will be to ensure that a realistic basis is used for the future cost-based pricing mechanism that has already been delayed

for several years. Once that is accomplished and when economic conditions improve, El Salvador and the private sector will be ready to move forward with currently postponed new electricity generation projects that will be needed to meet rising electricity demand when the economy starts to grow again.

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